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UNCLAS SECTION 01 OF 03 SAO PAULO 000264

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SENSITIVE

STATE PASS USTR FOR KDUCKWORTH
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DEPT OF TREASURY FOR JHOEK, BONEILL

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TAGS: [ECON](#) [EFIN](#) [EINV](#) [ETRD](#) [BR](#)
SUBJECT: BRAZILIAN SOVEREIGN WEALTH FUND BACK IN PLAY

SENSITIVE BUT UNCLASSIFIED--PLEASE TREAT ACCORDINGLY

REF: A. Sao Paulo 0053; B. Sao Paulo 0247; C. 07 Sao Paulo 0953; D.
Rio de Janeiro 091

¶1. (SBU) Summary: The May 13th announcement by Brazil's Finance Minister seeking to establish a sovereign wealth fund (SWF) for Brazil has been met with criticism from the financial community and concerns by the Central Bank. On the heels of this outpouring of negative press, President Lula asked Finance Minister Mantega to clarify the proposal before he decides whether to approve and submit the bill to Congress. Brazil's nebulous proposal for its SWF would not fit the traditional pattern of protecting against commodity price swings, but instead serve as a mechanism to sop up excess foreign currency in the domestic economy. In addition to potentially reducing the operational autonomy of the Central Bank in managing monetary policy, the Brazilian economy does not currently possess the optimal economic fundamentals that make a fund of this type appropriate. The drive to create this fund as well as the announced new industrial policy (septel) show a government increasingly interested in taking an active role in the Brazilian economy. A strong and largely autonomous Central Bank was key to Brazil recently obtaining the coveted investment grade rating, and anything that undermines that institution and increases uncertainty could have negative repercussions for the entire economy. End Summary.

¶2. (SBU) Despite enormous criticism and some incompatibility of Brazil's current economic conditions with a Sovereign Wealth Fund (SWF), Brazil's Finance Minister Guido Mantega formally announced a Brazilian SWF on May 13 after months of behind the scenes maneuvering. Following the announcement, President Lula delayed submission to Congress, asking Mantega to clarify his proposal's objectives. He also indicated that now may not be the right time to move forward on this proposal. As with the initial plan from February (Ref A), Brazil's controversial SWF proposal differs substantially from other nations' funds. Central Bank President Henrique Meirelles is known to have expressed concerns about a SWF and has publicly and frequently criticized the idea. One Central Bank concern was Brazil's foreign reserves, which has now been addressed as those reserves have now surpassed Brazil's gross external debt. Although the GOB has not announced the initial size of the SWF, Mantega suggested it would be between USD 15 and 20 billion. Mantega noted two financing sources, the excess tax

receipts above the 3.8 percent primary surplus target and by issuing new debt. (Note: In the first quarter, Brazil's primary surplus was 4.5 percent. End Note.) Mantega confirmed that Brazil's foreign reserves of USD 195 billion would not be touched.

¶3. (SBU) The GOB would need a majority in both houses of Congress if this proposal is introduced as a bill. It is more likely to be introduced as a provisional measure (similar to a presidential decree), which requires a vote within 120 days or the bill dies. Special Advisor at the Central Bank Alexandre Pundek informed Econoff that under Mantega's proposal for the Treasury to manage the SWF, the GOB would have to change Law 4595 which established monetary policy under the Central Bank's control. He opined that any effort to modify that law would likely face international backlash and as well as congressional opposition. Itau Bank Vice President Mauricio Oreng told Econoff that he does not think that Congress would approve the bill and believes opposition congressmen would question the contradictory role a SWF would play with that of the Central Bank.

Criticism Widespread

¶4. (SBU) Brazil remains a poor candidate for a SWF despite improved conditions since the GOB first suggested a SWF last October. In particular, two conditions often considered important for an SWF do not exist in Brazil: (1) a high level of national saving (Brazil's national saving rate is only 16 to 17 percent of GDP), and (2) a current account surplus (Brazil's current account is currently in deficit and is projected to decline). On the other hand, tax revenues have reached record levels, Brazil became a net creditor in February (meaning its foreign reserves are greater than its external

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obligations), and Brazilian debt became investment grade (Ref B) in April. Pundek told Econoff that Brazil does not have an inflow of revenues from a state-owned company that exports a major commodity. He noted that Brazil does not have a current account surplus and although Petrobras has made two significant oil discoveries (Refs C and D), the GOB would not see significant revenue flows until the two fields come online potentially as late as 2015. Pundek noted as well that Brazil still runs an overall fiscal deficit close to two percent of GDP and would have to increase its already burdensome debt profile to fund the SWF at a rate of approximately 12 percent.

¶5. (SBU) Critics have opposed both of the SWF's official objectives, which include building up domestic savings to stimulate economic growth in downturns and funding Brazilian companies abroad. The National Treasury would manage the SWF's investments in Brazilian exporters via overseas investments in private debt and equity. Critics argue that providing financing for the export sector does not help address Brazil's major export barriers: high and complex taxes, poor infrastructure, and onerous labor laws. Likewise, economist Daniel Weeks at Bradesco Bank noted to Econoff that the Brazilian Development Bank (BNDES) would likely finance large multinationals that do not need the money. Indeed, CEO Forum member Jorge Gerdau commented to Commercial Offs that his company had invested USD eight billion in the U.S. and did not need GOB funding for exports. Oreng agreed that rather than funding a vibrant private sector, the GOB should instead be investing in domestic infrastructure projects that would make Brazil more competitive. Weeks said the GOB's lack of concrete targets for its so-called countercyclical policy would leave the SWF available as another vehicle to hide government spending rather than using excess revenues to accelerate Brazil's payment of public sector debt.

¶6. (SBU) Critics condemned the two sources of funding for the SWF as well. Marcelo Solomon, Chief of Economic Research at Unibanco told Econoff that the lack of commitment to a higher primary surplus means the total contribution to the SWF remains uncertain. Furthermore, without a clear target or a credible signal from the GOB, he said it would be difficult to estimate the National Treasury intervention in the spot market. Solomon pointed out that the absence of a target also implies greater uncertainty in the role tighter fiscal policy could play on future monetary policy. Weeks

told Econoff that the second funding source was also problematic because the National Treasury would take some monetary policy control away from the Central Bank. He said the resulting confusion between the National Treasury and Central Bank, combined with the new role for BNDES to finance exporters, are very bad signs. Finally, a Credit Suisse economist told Econoff that investing abroad would carry a cost similar to holding foreign reserves; the SWF assets would potentially earn a lower return than the borrowing costs.

Politics Perhaps?

17. (SBU) Brazilian domestic politics helps explain why the GOB ultimately decided to create a SWF. The GOB can use the SWF to expand its direct role within the financial system, specifically via BNDES' purchase of private debt and equity. Mantega can also take credit for this high profile policy initiative to help overshadow his reputation as an ineffective and weak Finance Minister within the international finance community. Finally, Mantega noted that the SWF is a source of international prestige and helps put Brazil on par with other countries with SWFs such as China, Russia, and Saudi Arabia. Indeed, Solomon told Econoff that SWFs have become a status symbol for emerging market economies to manage their own wealth, but that a fund of USD 20 billion would be insignificant compared to others.

Comment

18. (SBU) The GOB's driving impulse behind the SWF appears to be a desire among some elements in the GOB to extend and expand the role of the government in the economy. The GOB would essentially assume the role of a private bank, determining the conditions for giving

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loans and making financial decisions perhaps best left up to the market. Many in the financial community see this as harking back to the 1980s, considered by many the "lost" decade for the Brazilian economy. What they see as the SWF's worst feature is BNDES' new role in picking winners and losers in its financing to Brazilian exporters. Together with the GOB's new industrial policy announced May 12 that increases the public sector's role in the economy(septel), the GOB appears to be continuing its internal struggle between those who support a more open approach and those whose instincts run toward the statist model. These moves, together with the recent increased role for state enterprises, suggest that some key Brazilian policy makers may at heart be strong interventionists. Ultimately, the SWF would take time to get through Congress given the backlog in provisional measures, the July holidays, and the upcoming municipal elections. Given President Lula's public contradiction of Mantega's statements (a not-uncommon occurrence), it remains unclear whether or when this proposal would move forward as the battle between the Central Bank and the Finance Ministry continues behind the scenes. Strangely, with the unspoken goal of curbing the appreciation of the currency, the SWF could instead have the contradictory effect of increasing foreign currency export earnings and putting more upward pressure on the Brazilian currency. If this fund does at some point make it through Congress and is ultimately used as a tool in setting monetary policy, there could be a significant negative impact to Brazil's economy as investors may become concerned about an increasing role of government in the private sector and the lack of autonomy of the Central Bank. End Comment.

19. (U) This cable has input from, was coordinated with, and cleared by Embassy Brasilia and coordinated with the US Treasury Financial Attache in Sao Paulo.

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